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FOMC Chart Show
July 1, 1997

As often seems to be the case, economic activity has been proceeding at an uneven pace in recent quarters, creating uncertainty about the "true" signal emanating from the data. Since the Greenbook was published we received more monthly information about spending in the second quarter: higher than expected consumption, but lower inventory investment and construction outlays. On balance, we would be inclined at this point to revise up our estimate of second-quarter GDP growth by about a quarter of a percentage point, to 2-1/2 percent. I should note that the charts show the forecast as published in the Greenbook.

Averaging through the first-quarter zig and the second-quarter zag, we think real GDP growth has been running in the neighborhood of a 4 percent annual rate so far this year. This clearly is an unsustainable pace, and we expect economic growth to slow gradually over the next year and a half. The basic rationale for the slowing was laid out for you in the Greenbook, and I won't go through the entire story. Suffice it to say that, in our view, a combination of waning stock demands for business and household investment goods and a moderate tightening of financial and credit conditions should damp aggregate demand.

We expect the unemployment rate to edge down during the remainder of this year. Next year, with output growing at around potential, the unemployment rate holds just above 4-1/2 percent--a degree of labor market resource utilization that we think is consistent with upward pressure on labor costs and, eventually, on prices. Indeed, as you can see from the middle column of the data panel in the lower right, the CPI excluding food and energy is projected to accelerate three-tenths of a percentage point-- between this year and next.

For what it's worth, the latest Blue Chip consensus forecast is telling a story similar to the staff's for GDP over the next year and a half. However, the average Blue Chip forecaster seems to have a higher estimate of potential GDP growth--that is, the projected growth of GDP in the Blue Chip consensus is not sufficient to keep the unemployment rate from rising. The Greenbook and the Blue Chip consensus project essentially the same inflation rate for the four quarters of 1998--suggesting that we are considerably more optimistic about the likely near-term trade-off between unemployment and inflation.

As shown in the upper panel of chart 2, our forecast is predicated on the assumption that the federal funds rate will remain at its current level through this year. But, as inflation pressures begin to mount and real rates drop, we assume that the nominal fed funds rate will move up about 50 basis points. The expectation that monetary policy will hold steady in the near term has helped fuel a rally in bond markets since the last FOMC meeting. However, as labor market pressures continue to tighten and credit demands grow, we think bond traders will lose some of their enthusiasm, and yields will begin to rise later this year. Reflecting the assumed System tightening, long-term rates are projected to rise a bit further next year--averaging about 7-1/4 percent in the second half of 1998.

We anticipate that the stock market will climb a little further in the next few months. But we think corporate profits will prove disappointing over time, and coupled with higher interest rates, this will lead to an appreciable market correction in 1998--on the order of 15 to 20 percent.

On the fiscal policy front, the federal deficit is expected to widen a touch next year as the growth of receipts slows--primarily because we don't anticipate another outsized jump in revenues like the ones we saw in the past two years. In addition, the budget resolution raised the caps on discretionary spending and this should add about $8 billion to nondefense outlays compared with the last Greenbook. But this is all pretty small stuff in the greater scheme of things, and as suggested by our measure of discretionary fiscal impetus, federal budget policy looks to be a virtually neutral element in the outlook for aggregate demand.

Ted will now discuss the prospects for the external sector.

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